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Food Fight

Why the conventional wisdom on crazy food prices is wrong.

WE SHOULD ALL TAKE A DEEP breath and stop complaining about the price of food. It is likely that food prices will come down, way down, by 2010. The usual culprits cited for the recent run-up, from speculators to poor Australian harvests to India and China, are not the bad guys here.

The newly prosperous in India and China are indeed having an impact but in a different manner than is commonly perceived. And financial speculators, who are being widely blamed for the problem, are stepping in where governments used to function, holding buffer stocks and warding off price hikes.

Poor Indians and Chinese are no longer serving as the world's shock absorber.

A glance at recent data helps explain what is going on. While the prices of wheat, corn, rice and soybeans have doubled in the last three years, there were no increases from 1990 to 2005. The futures market was alive and well during those years. If food prices had risen because speculators were hoarding, then inventories should have risen in this period. But worldwide food inventories went down, not up, from 2000 onward.

It's true that strong demand in India and China is having an effect on prices. But prosperity in these countries has risen since 1978. The simple story of people in these countries requiring food does not explain why food prices rose sharply after 2005. It's not just that Asians are getting richer and eating more. It's that poor Indians and Chinese are no longer serving as a shock absorber for the world.

In the old days when food prices went up, millions of people in India and China ate less. That made the world's demand for food quite elastic. When prices rose a bit, demand dropped enough to clear the market. Or to turn the elasticity formula around: The world adjusted to a fall in supply with a modest increase in price.

As people in India and China become wealthier, their behavior is changing. The new middle class is less price sensitive. Food prices would have to rise by more to crimp consumption. This makes the world food market more volatile: Large price changes come about when there are small supply shocks.

Prices affect supply, too, although not as quickly. More land is being cultivated, and technology is increasing yield. Once more food is available, prices will have to drop to bring supply and demand into alignment. Now these same effects will work in reverse: With a smaller shock absorber in India and China, a substantial drop in food prices will be required to equate supply and demand.

Speculators can do some good in smoothing the emerging boom-and-bust cycle. In order to keep food prices stable, governments used to operate commodity stabilization funds that would buy when prices were low and sell when prices were high. Now hedge funds and other speculators are stepping into government's role.

When food prices are low and the forecast is for future prices to go up, speculators buy up food and wait for the time when food will be in great need. They serve as buffer stocks, driving up prices today when food is too cheap and being very useful in the future when food is going to be expensive. These actions, holding inventory when future prices are expected to be high and shedding inventories when future prices are expected to be low, help smooth out price fluctuations and perform the same function as the old government commodity stabilization funds.

For such actions to have a large impact on the food market, they have to take place at a substantial scale. Large blocks of capital need to be invested in holding inventories. There are signs that this is coming about. Investors, aided by information from futures markets, are increasingly prominent in commodities, acting where governments once functioned.

With prosperity in Asia diminishing the world's shock absorber, the world food market will be volatile. Profit-minded speculators are ready to pounce on this volatility. Let's welcome them. Their actions will dampen volatility. F

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